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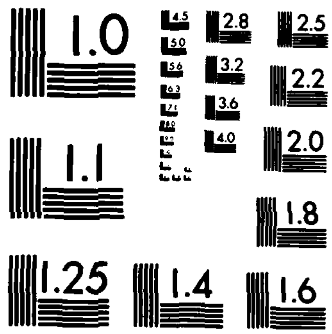

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ECONOMIC INCENTIVES TO MERGE:

TESTIMONY BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

We will present the key findings of research conducted by The Rand Corporation on behalf of the Small Business Administration. The views and conclusions expressed are our own and should not be interpreted as representing those of Rand or the Small Business Administration.

The ownership structure of the daily newspaper industry has been undergoing some rather dramatic changes during the twentieth century. The industry was once dominated by small, family-owned enterprises. In 1910, for example, there existed only 13 companies owning more than a single newspaper firm. Thus, only three percent of all U.S. daily newspapers were members of chains. Today, about 70 percent of all establishments are subsidiaries of larger corporations. Our research project examined the economic causes of this newspaper conglomeration.

Merger activity can be the consequence of a variety of economic phenomena. For example, there may exist multi-firm economies of scale. A newspaper chain might be more efficient and be able to produce at lower per unit costs. Also, big firms may enjoy pecuniary advantages. That is, newspaper firms may obtain inputs at lower prices. In addition, the industry has undergone a technological revolution. Group membership could facilitate adaptation to rapid changes in technology. Finally, tax incentives to both buy and sell can play important roles in merger activity. The research provided an empirical examination of each of these potential motives to merge.

ECONOMIES OF SCALE

If groups are more efficient than independent newspapers, the merger activity may be due to economies of scale. Cost savings can stem from a variety of sources. Perhaps groups can produce news, features, and advertising centrally and distribute content at low marginal costs to member newspapers. Also, there may be economies of scale in management. For instance, chains generally maintain a squad of trouble shooter specialists who contribute expertise to member newspapers that may be weak in marketing, distribution, or production.

However, despite these conventional wisdoms concerning the economic advantages of chains, there are reasons to doubt their importance to the changing structure of the industry. Most significantly, external markets have evolved to provide services which are internal to large groups. For example, national advertising agencies can minimize transactions costs for independent newspapers. The development of the wire services and feature syndicates provides sufficient volumes of centrally produced material for independent firms.

To test this proposition, a model of the daily newspaper was developed and estimated using data from a mail survey of firms. Under the standard assumption that firms maximize profits, it was possible to compare implied marginal costs of production for independents with group newspapers. The empirical results were not ambiguous. For the production of circulation, advertising space, and news content, group newspapers did not exhibit marginal costs which were significantly lower. There was no evidence for multi-plant economies of scale.

It is possible that the results are biased by misspecification of the model or the underlying behavioral assumption of profit maximization. Further work in this area is desirable. However, the econometric results are robust and consistent with past research as well as the conventional wisdoms concerning the newspaper industry. Thus, it seems doubtful that the evolving ownership structure of the newspaper industry is due to economies of scale.

PECUNIARY ECONOMIES

An empirical examination of newspaper input prices was undertaken to test the proposition that groups enjoy financial advantages. For example, chain newspapers might realize savings by purchasing newsprint in bulk. Also, groups could be better equipped to deal with labor unions. If this is true, wage expenditures will be lower for chain newspapers.

Data on newsprint prices and wages for several categories of labor were utilized in an empirical study. The evidence suggested that group affiliation does not confer any pecuniary advantages to member newspapers. Newsprint prices facing individual firms appear to be determined in national markets. Firm specific characteristics proved to be useless in explaining the variation in the average price of newsprint consumed during the 1979 fiscal year. The empirical description of wage differentials resulted in the same conclusion. Wages do not systematically vary by ownership characteristics. All things equal, group newspapers pay the same prices for inputs. Thus, pecuniary economies can not explain the wave of merger activity.

TECHNOLOGICAL DIFFUSION IN THE NEWSPAPER INDUSTRY

The past decade had been marked by an electronic revolution in the newspaper industry. Indeed, every facet of newspaper production has been affected by the increased utilization of new computer technologies. For a variety of reasons, large firms may be better suited to technological change. To begin with, big corporations may have capital market advantages that are realized via better access to financial markets or because internal distributions of capital are more efficient. In addition, newspaper chains can sequentially adopt new technology in separate establishments thereby minimizing risk, developing transferable computer software, and benefiting from a "learning curve."

These potential advantages are the basis of some of the more convincing arguments suggesting that the growth in newspaper chains stems from existence of economic efficiencies. If the cost of adoption of the new technology for a newspaper is lower for a chain member, mergers will be encouraged. The same conclusion holds if the benefits of computerization are higher for chains due to facilitated interfirm transfers of features, news, or advertising content.

However, equipment suppliers and manufacturers have incentives to provide software in the marketing of new technologies. Also, the transfer of new technology has been facilitated by extremely active trade associations. These associations support research laboratories, hold conventions and exhibitions, and disseminate information to members. For these reasons, the supposed technological advantages enjoyed by chain newspapers are likely to be minimized.

Two models of technological diffusion were developed and estimated. The evidence suggests that the size of the individual newspaper is positively correlated with the rate of diffusion. However, there exists a size threshold beyond which size is no longer a factor. On the other hand, group newspapers have not, in general, adopted at a faster pace. There is some evidence that small, regional groups began utilizing certain technologies earlier. However, large groups exhibit no apparent advantage. Thus, the growth in newspaper chains can not be explained in terms of more efficient adaptation to technological change.

TAX INCENTIVES AND NEWSPAPER MERGERS

Economists have long recognized the importance of tax laws in encouraging mergers. Tax laws can create incentives to sell as well as to buy. First, current estate tax rules can make it impossible for heirs to retain ownership of the newspaper firm. The high marginal tax rates in combination with IRS valuation methods based on newspaper firm transaction prices result in annual estate tax liabilities which exceed operating income. In addition, tax laws create incentives to acquire firms. These stem from a variety of tax policies. For example, the wedge between capital gains and personal income tax rates motivates mergers if a subsequent stock appreciation converts potential dividend earnings into asset value growth. The case law on accumulated earnings also creates motives for merger. Corporations can avoid a substantial tax surcharge on excess accumulated earnings by making merger acquisitions. Finally, laws regarding loss carry forward provisions, treatment of depreciation, and tax-free stock exchanges can all create incentives to merge.

In order to measure the potential magnitude of the tax motivation, a model was developed and applied to newspaper transactions occurring since 1972. To quantify the potential impact of tax regulations, it was assumed that firms will pay a price which is equivalent to the present value of the expected stream of future profits associated with the acquisition. Estimates of the magnitude of the incentives suggest that the acquiring firm can save at least 25 cents in taxes for each dollar expended.

Unfortunately, estimates of the magnitude of the tax parameters are highly sensitive with respect to the assumptions of the estimating model. In particular, the discount rate employed in the analysis is subject to considerable uncertainty. A more direct test of the tax incentives is desirable and should have highest priority in future research. However, the estimates are intuitively plausible and the qualitative conclusions are defensible. That is, the tax laws create economic incentives for merger that are likely to be quite large. Although the Economic Recovery Act of 1981 will diminish the incentives to some extent, tax law will continue to promote merger activity.

CONCLUSIONS AND POLICY RECOMMENDATIONS

The research conducted suggests that the increased importance of newspaper chains is not the result of efficiency gains due to conglomeration. The consistent absence of evidence that group ownership matters is quite convincing. There are no measurable advantages in input markets, multifirm scale economies, or differences in the rate of

technological diffusion. For the most part, independent firms are indistinguishable from newspapers that are subsidiaries of larger corporations. In addition, groups do not significantly alter the performance of the newspapers they purchase.

These conclusions do warrant further investigation. In particular, systematic deviations from the presumption of profit maximizing behavior on the part of newspaper managers could alter the results. Also, a better characterization of the process of technological diffusion within newspaper groups is desirable. Finally, the recent release of 1980 Census data permits a more detailed and reliable description of the local newspaper markets. Thus, the more precise identification of several factors which influence the demand for newspaper products can be made. Of special interest are the roles of market demographics, regional characteristics, and the nature of media competition.

However, these extensions would, in all likelihood, not alter the conclusions. The empirical results were extremely robust and quite insensitive to alternative specifications of the underlying models. In addition, they are consistent with several institutional factors as well as previous research in this area.

On the other hand, tax laws can provide strong economic incentives for merger. In the absence of alternative economic motivations, we are left with the implication that tax laws are a primary cause of mergers in the newspaper industry. The generalization of this result to other industries should have the highest priority in future research.

These results have important policy implications. Surely, a democratic society depends on a diverse forum for the creation, assimila-

tion, and dissemination of ideas and information. Corporate acquisitions of daily newspapers, as well as weeklies and cable television franchises continue. To the extent that such merger activity is encouraged by tax laws which appear to have little or no economic justification, government agencies with the appropriate jurisdiction should consider remedial policies. On the other hand, the absence of evidence that group newspapers, on average, operate in a manner which is measurably different from independents can be given a positive interpretation. That is, the existence of several group newspapers, none of which dominates a large percentage of U.S. circulation, does not yet have very important ramifications.

More importantly, our analysis of newspaper groups does have more general policy implications. The tax benefits identified are likely to be a primary motivation in the merger activity occurring elsewhere. If these policies were meant to stimulate the types of investment which add to the economy's real stock of capital but instead simply encourage transfers of property, they need to be reevaluated. The following changes should be considered.

1. Estate taxes can force heirs to relinquish properties. Although recent changes in the tax rates and terms of payment should alleviate the problem, heirs will, in usual circumstances, be unable to pay taxes out of current earnings. Perhaps IRS estate tax valuations should be based on the probable income of the ongoing business, not market value.
2. Provisions for the assessment of excess accumulated earnings penalties might be revised. First, accumulations for future

estate taxes could be allowed. Secondly, the standards for accumulations for "reasonable business" needs can create a distortion. The lenient case law in the case of newspaper groups which occasionally purchase other properties might be made more stringent. In addition, the requirement that firms grow only in related industries actually creates disincentives for investment. This was not the intention of the law.

3. The rules for depreciation, capital gains rates, and investment tax credits are meant to stimulate net growth in the economy. We have seen that they may, instead, merely encourage interfirm transfers with no net benefit to society. The tax structure was not meant to encourage mergers. Policy makers should consider changes which make distinctions between real investments and the purchases of existing assets.
4. Finally, loss carry forward provisions create incentives for acquisition that can be substantial. In the absence of any economic justification for these provisions, they need to be reconsidered.